First

CAPITAL MARKETS OUTLOOK

First Quarter 2017

The Economy

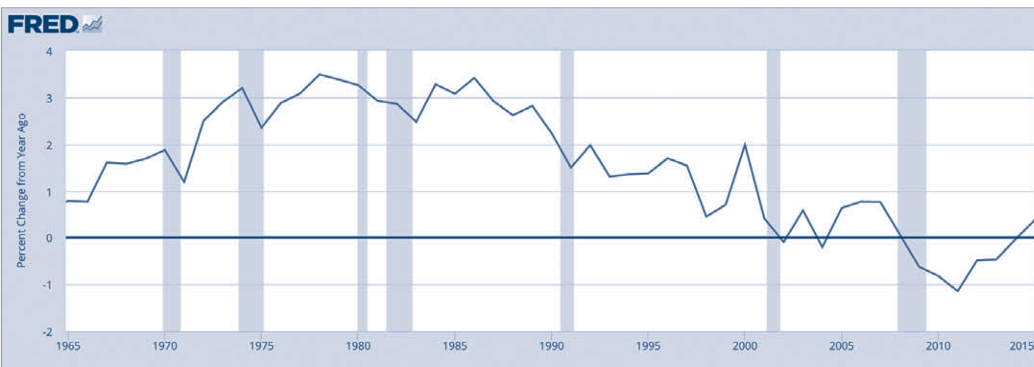
We expect the low but steady growth that has defined this expansion to continue in 2017. The US is going on its eighth year since the financial crisis. The consensus forecast for GDP growth (from the Wall Street Journal's monthly survey of sixty economists) has the US at around 2.4% in 2017. Central banks remain accommodative.

A tightening labor market and healthy household balance sheets bode well for the future, as does prospective fiscal stimulus from the US government. There are political risks however from the uncertainty around the incoming administration. The populist current is not restricted to the US – and Europe has a busy upcoming election schedule.

The consensus expectations are for the Fed to raise rates two to three times this year. Raising rates are not only needed to temper potential inflation. The Fed also needs to re-load the monetary-policy gun to fight the next recession (whenever that occurs). We think the Fed would be reluctant to engage in negative interest rate policy, and they won't be able to cut rates sometime in the future unless they are off the rate floor. In any case, central bank policy will continue to be relatively accommodative for the foreseeable future. We think there is low risk of Fed credit tightening causing a recession in the next year. Globally, the UK looks to follow the US's lead in gradually raising target rates. The Eurozone is expected to as well, but negative interest rate policy will likely continue for the next couple of years. Japan, who has the longest history of near-zero rates, is not projected to tighten. If other central banks do not keep pace with US tightening, global interest rates could diverge further, making the dollar more attractive and subsequently strengthening versus other currencies. A stronger dollar would make imports cheaper and undercut inflation but also potentially dampen export demand growth.

Janet Yellen noted that the US labor market looks similar to how it did before the recession. At 4.72%, headline unemployment is likely at the natural rate. The natural rate of unemployment

Civilian Labor Force Level: Aged 24 to 54 years



Source:: Federal Reserve Bank of St. Louis, J.P. Morgan Asset Management, Wall Street Journal, Capital Economics, Goldman Sachs

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Capital Markets Outlook is published quarterly by Asset Strategy Consultants.

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can be thought of as unemployment not due to the business cycle – e.g. unemployment due to industry reorganization or people voluntarily looking for better jobs. Concerns about low wage growth are also starting to alleviate as the labor market tightens. This may pull up inflation which to this point has been very placid, despite unprecedented central bank policy. Core PCE inflation stood at 1.6% (year-on-year) in November, down from 1.8% the month before, and below the Fed's understood target of 2%. If Trump is successful in administering large fiscal stimulus, this could also add to inflationary pressures. There is no historical precedent of the US employing fiscal stimulus at a time of full employment and a generally-healthy economy.

Any way it is measured, economic growth is a function of people. All other things held constant, a working-age population produces more than a retiree population and a larger population produces more than a smaller population. The US is very likely seeing a sustained slowdown in the growth of its working population.

While there do not appear to be any explicit headwinds in the horizon, there are structural shifts in the developed economies that we think should be considered when setting long-term growth expectations. This is the fourth longest expansion since 1900 in the US, but growth has averaged only 2.1%. Demographics are shifting as baby boomers start to retire. The U.S. Administration on Aging projects that by 2030, a quarter of the population will be over the age of sixty-five. Compare this with the post-war-to-2000 years, when that number ranged between 12% and 17%. Since 2000, when the Civilian Labor Force Level (defined as population aged 25 to 54 years, working or looking for work) grew at 1.98% year-on-year, the annual average growth rate has not broken 1%. Productivity growth, the other variable in the GDP-growth function, has also slowed. Average annual productivity growth was 2.1% in the post-war to 2011 period, but only 0.5% since. We think this factor is less compelling however, as productivity is difficult to measure since the US pivoted to a primarily service-oriented economy. Any way it is measured, economic growth is a function of people. All other things held constant, a working-age population produces more than a retiree population and a larger population produces more than a smaller population. The US is very likely seeing a sustained slowdown in the growth of its working population. And we think it is unlikely that any productivity gains, whether from technology or a more market-friendly government, can overcome this. The post-war domestic growth we've been accustomed to may be a historical anomaly – what we've seen since the financial crisis is probably a better indicator of what's to come. ❖

Capital Markets

Domestic Equities

Domestic equities posted positive returns for 2016 and ended the year at all-time highs. The S&P 500 gained 12.0% for the year while the Russell 2000 led the charge gaining 21.3%. The year marked a turnaround for styles as value outperformed growth across all cap ranges with the biggest spread in the small caps 31.7% small value compared to 11.3% small growth. All sectors within the S&P had positive returns other than Healthcare -2.7%. The top performing sector was Energy 27.4% as oil prices had a nice rebound during the year as prices had reached rock bottom in February and OPEC agreed to cut production in September. The Brexit/EU-related uncertainty is likely to be felt in both the consumer and business channels. Although consumer confidence was dented, their remains continued support for consumer spending, including low interest rates, higher wages, better housing data, and a healthy employment picture. The election of Trump spurred a market rally in the last month and a half to put indices at all time market highs. Even with policy changes uncertain, the market has priced in stronger growth, higher inflation and high expectations for de-regulation. Looking ahead, returns remain constrained as earnings growth is dampened by a modest economic growth environment and starting valuations remain elevated as shown by the S&P 500 12-month forward looking P/E ratio at 16.9x which is ahead of the 25 year average of 15.9x. The S&P 500 is expected to rise to 2400 during the 2017 calendar year, however, will end the year around 2300.

Developed Equities

After the uncertainly surrounding the Brexit in the early second half of the year, the Eurozone growth was able to remain steady. Then came the unexpected win of Donald Trump in the U.S. that shook the global economy, pushing the Euro to the lowest level in nearly a year in November. Global market seems to have calmed after the initial shock of U.S. election results but the implications of the new administration are harder to predict. U.S. election was followed by Italian voters' rejection of constitutional reforms. Through all the political turmoil, global economy seems to have managed to remain weak but stable. Eurozone economic growth for the year was fueled by the strong domestic demand, supported due to downward shifting unemployment trend, ultra-loose monetary policy, and low price pressure.

Looking ahead, the Eurozone is expected to face further headwinds with political uncertainties surrounding strength of populist gains in upcoming elections and inflation could limit the speed of growth. The EU expects the Eurozone results to slow to 1.7% in 2016 and decelerate further to 1.5% in 2017. Whereas, Britain's GDP is expected to pick up to 1.9% in 2016, before slowing down to 1.0% in 2017, slow growth is expected as the decision to leave the EU delays construction projects, capital

spending plans, and hiring decisions.

Japan is still struggling with Abenomics contributing very little to growth and inflation; GDP is expected to have a modest growth at just 0.5% for this year and 0.9% for 2017.

Emerging Markets

Emerging markets (EM) returned 11.2% in 2016 with a bulk of the appreciation occurring during the more momentum driven March and September quarters. In contrast to the September quarter, the MSCI Emerging Markets Index declined 4.2% in the December quarter. Among emerging markets, Russia posted the best return (+19%) while Turkey (-14%) sank. Turkey's economy shrank 1.8% in the third quarter, its first year-over-year decline since 2009. Mexico, hurt by Trumponomic concerns, was down 8%. The Trump administration has heightened uncertainty and intensified headwinds for EMs. Potential protectionist legislation on trade and large scale profit repatriation could be negative for the region. In the event of inflation, a hawkish Fed could cap dollar appreciation and possibly soften any potential negative impact. EM typically benefits from global trading activity. In 2017, global economic growth is expected remain stable in the 2.5% range. Within EM, GDP growth is expected to improve year-over-year to the low 4% range from high 3% range. Year-over-year growth is projected to be driven by cyclical recovery in Russia and Brazil, with India and China making contributions as well. India is projected to generate just over 7% GDP growth, as consumer spending continues to outpace manufacturing and investment.

Fixed Income

The post-election impact on the bond market was dramatic, as U.S. fiscal policy is expected to steepen the yield curve. In addition, the US Federal Reserve increased Fed Funds rate in December, for the second time in as many years. As a result, the 10-year yield rose to a high of 2.6% in mid-December, well above its low of 1.4% (July). For the month of November, the Bloomberg Barclays Aggregate index was down 2.4% and for the 4th quarter finished down 2.98%. According to Goldman Sachs, average year-over-year global economic growth in 2017 will be 3.2%, the same pace we have experience since 2008. Meanwhile, other central banks are abandoning their negative rate strategies in order to stimulate economic growth. The ECB and Bank of Japan have begun to hint at transitioning to a more credit oriented monetary policy. In the U.S., tighter credit spreads and record leverage reflect late-cycle conditions that leave investors cautious on investment grade and high yield beta. Based on anticipated fiscal and administrative policies, a few industries could see spreads continue to tighten, including energy and pharmaceuticals. In the short term, Emerging Market (EM) hard currency bonds should outperform, and EM sovereign credit risk is still cheaply priced relative to underlying fundamentals, according to Prudential. Domestically, non-agency MBS and collateralized loan obligations (CLO) are attractive in a rising interest rate environment. ❖

Alternative Investments

Hedge Funds

Hedge funds ended the year up 4.5%, in what proved to be a fairly tricky environment for most fund managers in 2016. Many were caught by surprise by the different event outcomes over the course of the year. International exposure and shorts detracted from returns in general. According to P&I, the hedge fund industry shrank in 2016 with $106 billion in net outflows. Despite the lackluster returns and recent redemptions, hedge fund assets still ended the year over $3 trillion. Looking forward to 2017, it is anticipated that there will be ongoing political and economic events that will bring more uncertainty to the markets. It is still unclear how markets will react once Donald Trump takes office later in January. The common consensus is that uncertainty breeds volatility, which is typically good for hedge fund strategies.

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Areas of the market that look attractive going forward are Event Driven strategies that are finding a steady flow of opportunities, as many large companies are struggling to find new ways to grow organically. To solve this problem they are looking to merge, spin-out, or reorganize parts of their business. Global Macro managers are another segment of the hedge fund space that have a rich opportunity set as central banks have begun to act in a less coordinated manner and are making decisions based on their own local economic conditions. On the credit side, the looming rate hike presents managers that have a strong trading acumen an opportunity to use their expertise in shorting. Markets expect muted returns from traditional asset classes over the next several years and are therefore pondering where they will be able to get alpha going forward. Hedge fund portfolios have significantly outperformed the S&P 500 after markets have reached peak valuation levels in the past.

Private Equity

The private equity market maintained good liquidity during the third quarter as the environment for fundraising and investing remained favorable. The benefits of private equity were highlighted by a recent Callan survey of clients finding that those with mature portfolios received cash distributions of between 20% and 25% of the portfolio's net asset value, a healthy sign. According to Buyouts magazine, investments into companies in the third quarter maintained momentum, totaling

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385 transactions, an increase of 8% over the second quarter but down slightly from 406 a year prior. There were 142 private M&A exits of buyout-backed companies, a 20% increase from the second quarter. Eight of those exits topped $1 billion.

Investments in venture capital companies totaled 1,796 rounds and $15 billion of volume, according to the NVCA. This volume is down somewhat due to the second quarter's unusually large volume due to the Uber placement of $3.5 billion alone. The largest venture backed M&A exit came from retailer Jet.com that was sold to Walmart for $3.3 billion and backed by Accel, Bain, NEA and others. There were 14 VC-backed IPOs for a combined value of $1.2 billion in the third quarter. This is up from 13 IPOs with issuance of $876 million in the second quarter. The largest exit was Nutanix for $238 million.

The Thomson Reuters/Cambridge database All Private Equity return over 10 years through June 30, 2016 of 10.3% is ahead of both the S&P500 and Russell 3000 index return of 7.4%. This time period is the most appropriate to consider since it incorporates one or more full market cycles.

Real Estate

A lengthened economic cycle and favorable supply/demand fundamentals still point to an extended real estate cycle, although some believe we are probably nearing the 7th inning.

> Most institutional clients are focused on adding value-add strategies, indicating a strong interest in these higher return, alpha-generating strategies

Strong core pricing is still supported by low global interest rates and positive fundamentals. North America continues to be the primary destination for investor capital, but interest in other geographies has increased substantially. Non-core real estate continues to be less efficient selling at wide discounts to core, though it too has recovered from recessionary levels. Most institutional clients are focused on adding value-add strategies, indicating a strong interest in these higher return, alpha-generating strategies. What could derail the real estate market at this point in the cycle is too much supply and/or too much debt, but there really isn't much evidence to support that case yet, although there are some pockets of the market that do feel a bit frothy like U.S. multi-family and London office space. Even some market observers like Callan Associates have warned their clients to take a cautionary stance and are tempering expectations for commercial real estate. About half of the seven different indicators they follow currently point towards real estate becoming overheated. ❖